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The burden of attention: CEO publicity and tax avoidance☆

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ABSTRACT

We use search volume index (SVI) for a CEO's name and stock ticker from Google Trends to measure CEO publicity, and examine the competing hypotheses on its relation to tax avoidance. On the one hand, CEOs who receive more attention from retail investors may engage in tax evasion activities to meet investors' performance expectations; on the other hand, they are more concerned with public image and avoiding being labeled as tax avoiders. Based on the CEOs of S&P 500 firms between 2004 and 2011, our finding supports the former and shows that CEOs with higher publicity manage to have a lower effective tax rate and cash effective tax rate. Such effect is moderated by board independence. Finally, firms with higher CEO publicity pay auditors higher tax fees, suggesting that these CEOs tend to use more tax planning services from auditors.

1. Introduction

Managers have a significant impact on their corporate tax avoidance that cannot be explained by firm-level characteristics (Dyreng, Hanlon, & Maydew, 2010). They study leaves on the what specific characteristics of managers affect corporate tax avoidance? Following the seminal work of Dyreng et al. (2010), Olsen and Stekelberg (2016) show that narcissistic CEOs are more likely to engage in tax avoidance because they have high self-entitlement, are exploitative, and lack moral sensibility. Law and Mills (2017) find that CEOs with military experience are less likely to engage in tax avoidance because they share the common value with government legitimacy and are more ethical. This paper studies CEO publicity as a new dimension of CEO characteristics, and examines its effects on firms' tax avoidance behavior. Publicity refers to the attention given to CEOs by retail investors.

We suggest that CEOs can influence corporate strategy, including tax policy, by setting the tone at the top and influencing the corporate culture. Corporate culture is a collective phenomenon emerging from the members' beliefs and social interaction, containing shared values, mutual understanding, and behavioral expectations that tie individuals in an organization together over time (Schein, 2004). Upper echelon leaders have primary attributes of organizational culture (Schein, 2004; Trice & Beyer, 1993). If some CEOs are inclined to aggressively avoid tax, they would recruit executives with similar values and beliefs to join the top management team (TMT). As a team, they are able to structure transactions to re-allocate taxable income from a high tax rate regime to a low tax rate regime, employ transfer pricing initiatives, set up offshore intellectual property havens, and centralize operating activities in tax-friendly jurisdictions to minimize overall corporate tax or assert the intention to permanently re-invest foreign earnings and not accrue incremental US tax expense upon repatriation (Dharmapala & Hines, 2009; Dharmapala & Riedel, 2013; Powers, Robinson, & Stomberg, 2016).

We hypothesize opposing effects of CEO publicity on tax avoidance. On the one hand, CEOs with higher public attention care more about investors' expectations and therefore use aggressive tax planning strategies to increase earnings. Malmendier and Tate (2009) show that investors' expectations of future firm performance are higher for superstar CEOs. Because failing to meet investors' expectations could be detrimental to CEOs' public image and future career, CEOs with higher publicity may use tax avoidance to increase earnings to meet or beat performance expectations. CEO publicity is therefore positively associated with firms' tax avoidance behavior.

On the other hand, tax avoidance can be costly to CEOs. For example, tax avoidance can result in a higher probability of a tax audit, leading to an assessment of additional taxes, fines, interest, and

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penalties by tax authorities (Mills, Erickson, & Maydew, 1998). A survey conducted by Graham, Hanlon, Shevlin, and Shroff (2014) shows that almost half of respondents agree that an unfavorable consequence of aggressive tax avoidance is the potential harm to a firm's reputation. When tax avoidance activities are identified and penalized by the Internal Revenue Service (IRS), CEO publicity exaggerates the loss in terms of credibility and future career opportunities. These CEOs may suffer from a decline in social status and esteem. This suggests that CEO publicity can be negatively associated with tax avoidance behavior. The net effect of CEO publicity presents a timely and important research question.

Our sample includes CEOs of S&P 500 firms between 2004 and 2011. We use the search volume index (SVI) for each CEO's full name, plus the stock ticker of the company provided by Google Trends as a proxy for CEO publicity.[1] Google is arguably the most convenient tool for individual investors to search for information about CEOs on the internet. Ding and Hou (2015) argue that SVI captures the active attention of retail investors. CEOs with larger SVI(s) therefore receive more publicity. Different from the indicator of superstar CEOs (Malmendier & Tate, 2009), which is observed for a very small proportion of CEOs, our publicity proxy provides a continuous measure for many CEOs. In addition, the traditional measures of CEO reputation can only explain about 11% of the variation in CEO publicity, showing that CEO publicity captures a new dimension of CEO characteristics.

We find that CEO publicity is associated with a higher level of tax avoidance activities, as indicated by the lower effective tax rate and cash effective tax rate. The effect is both statistically and economically significant. A one standard deviation increase from the mean of publicity measure leads to a 3.8% decrease in effective tax rate. The positive effect of CEO publicity on firms' tax avoidance activities is more pronounced among firms with less independent boards, implying the effective role of outside directors in moderating the aggressive tax avoidance by CEOs with high publicity. Finally, CEO publicity is positively associated with the level of tax fees paid to external auditors, showing that CEOs with high publicity use more services related to tax planning from auditing firms.

There are a number of alternative interpretations that are compatible with our results. For example, there might be confounding effects of other CEO characteristics or industry attributes. We find that the results are robust to the inclusion of CEO media coverage, age, gender, outside CEO, earnings management, year and industry fixed effects, as well as the propensity score matching (PSM) approach. To address the concern of reverse causality, we apply the dynamic panel GMM estimator and find the results consistent.

Our contribution to the literature is three-fold. First, this study complements the growing literature on the effects of CEO characteristics on firm outcomes, and tax avoidance in particular. Since Bertrand and Schoar (2003) and Dyreng et al. (2010), an increasing number of studies identify the managerial effects of CEO characteristics, including superstar status (Malmendier & Tate, 2009), reputation (Francis, Huang, Rajgopal, & Zang, 2008), ability (Baik, Farber, & Lee, 2011; Demerjian, Lev, Lewis, & McVay, 2012.), facial masculinity (Kamiya, Kim, & Suh, 2016), signature size (Ham, Seybert, & Wang, 2017), and overseas experience (Duan & Hou, 2017). Law and Mills (2017) find that CEOs with military experience pursue less tax avoidance. We use SVI to measure CEO publicity, a new dimension of CEO characteristics, and provide original evidence on its positive impact on tax avoidance.

Second, this paper adds to the literature on tax avoidance and the "under-sheltering puzzle" (Dowling, 2014; Gallemore, Maydew, & Thornock, 2013; Hanlon & Heitzman, 2010) by identifying a new source of variation in firms' engagement in tax avoidance. While prior literature examines influential factors, including incentives for managers (Desai & Dharmapala, 2006), family ownership (Chen, Chen, Cheng, & Shevlin, 2010), labor union (Chyz, Leung, Li, & Rui, 2013), and board ties to low-tax firms (Brown & Drake, 2014), this study focuses on CEO publicity and finds it helpful in explaining the variation in the effective tax rate of US public firms.

The rest of the paper proceeds as follows. Section 2 proposes the competing hypotheses. Section 3 introduces the setting and research design. Sections 4 and 5 report the empirical results and robustness checks. Section 6 concludes.

2. Competing hypotheses

The high publicity of CEOs may increase the market's expectations. These CEOs therefore would be under greater pressure to increase reported earnings. Brown and Caylor (2006) show that managers' focus has shifted from avoiding losses or earnings decrease to meeting or beating analysts' expectations since the 1990s. Firms receive more positive valuation for meeting or beating analysts' expectations. When they find it difficult to meet investors' expectations, they may choose to use aggressive tax planning strategies to reduce the overall tax expense for their firm. For example, Graham et al. (2014) find that 61% of executives in their surveyed companies indicate that it is important that tax strategies do not reduce earnings per share (EPS), and 49% respond that it is important that tax strategies lead to high EPS. Furthermore, every dollar saved from reduced tax can be redeployed to more productive uses. For a firm that faces financial constraints in funding its profitable investment opportunities, the cash savings from tax expenses can be utilized to finance these investments, which would otherwise never be achieved (Edwards, Schwab, & Shelvin, 2012). Based on this discussion, we propose H1a as follows:

H1a. CEO publicity is positively associated with firms' tax avoidance behavior.

There are also reasons for CEOs with high publicity not to engage in tax avoidance. When a company's aggressive tax avoidance behavior is identified by the tax authority and reported by the media, reputation costs are imposed on the company and CEO. In a survey of tax executives, Graham et al. (2014) find that almost half agree that potential harm to their firm's reputation is a very important factor in deciding whether to implement an (aggressive) tax planning strategy. Moreover, the Commissioner of the Internal Revenue Service (IRS) contends that the general public has little tolerance for overly aggressive tax planning, and aggressive tax strategies lead to the loss of customer loyalty and damaged corporate image. For example, an article published in the *New York Times* on March 24th, 2011, responded to the fact that General Electricity (GE) paid virtually no tax to the US government in 2011 by noting, "critics say assertive tax avoidance of multinationals (such as GE) not only short changes the Treasury but also harms the economy by discouraging investment and employment in the US" (Kocieniewski, 2011). Furthermore, commentators reacted by advocating, "this company (GE) should be boycotted." Aggressive tax avoidance is also likely to negatively affect the future careers of CEOs of companies undertaking such behavior. Therefore, managers have to trade off these costs against the expected benefits associated with tax avoidance. The publicity of CEOs can exaggerate the potential reputation cost if their tax avoidance activities are detected. If CEOs believe that the marginal cost of tax avoidance (i.e., adverse career perspective) exceeds the marginal benefit (i.e., increased earnings), they are induced to reduce the extent to which their firms engage in tax avoidance behavior. We hereby propose the competing hypothesis as follows:

H1b. CEO publicity is negatively associated with firms' tax avoidance behavior.

[1] Consistent with previous studies that count press articles as a measure of CEOs' status (Milbourn, 2003), we require a concurrent search for the stock ticker of the firm to avoid over-stated searches for common names such as John Smith.